

VZCZCXRO3176
PP RUEHAG RUEHDF RUEHIK RUEHLZ RUEHROV
DE RUEHLO #2683/01 2980940
ZNR UUUUU ZZH
P 240940Z OCT 08
FM AMEMBASSY LONDON
TO RUEHC/SECSTATE WASHDC PRIORITY 0191
INFO RUCNMEM/EU MEMBER STATES COLLECTIVE PRIORITY
RUCPDO/DEPT OF COMMERCE WASHDC PRIORITY
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
RUEHBL/AMCONSUL BELFAST PRIORITY 1147
RUEHED/AMCONSUL EDINBURGH PRIORITY 1005

UNCLAS SECTION 01 OF 02 LONDON 002683

SENSITIVE
SIPDIS

E.O. 12958: N/A
TAGS: [ECON](#) [EFIN](#) [ETRD](#) [EINV](#) [UK](#)
SUBJECT: HMG ACKNOWLEDGES UK ECONOMY ENTERING RECESSION

LONDON 00002683 001.2 OF 002

¶1. (SBU) Summary: This week, officials publicly acknowledged that the UK is likely to be entering a recession. For months, prominent public figures refused to mention the 'R' word, in favor of talking up the underlying strength of the UK's economic position. However, Mervyn King, Governor of the Bank of England, broke the silence and explicitly acknowledged that the UK is likely to enter a recession. His comment was soon echoed by PM Brown and supported by independent forecasts. Such a bleak horizon has pushed sterling to a five-year low against the dollar while equity prices continue to fall. Despite a record public deficit, HMG has announced that it will borrow more to invest in projects that will help stimulate the economy. The opposition has accused PM Brown of presiding over a decade of heavy borrowing and lax regulation which has aggravated the impact of the credit crunch. End Summary.

Governor King Uses The 'R' Word As GDP Growth Turns Negative

¶2. (SBU) The UK economy is likely to be entering a recession, according to Mervyn King, Governor of the Bank of England, in his gloomiest assessment of the UK outlook since becoming Governor in ¶2003. His comments were supported by confirmation that GDP growth was negative 0.5 percent in the third quarter. King told business executives that the credit crunch, combined with a fall in real disposable incomes, poses the risk of a prolonged slowdown in domestic demand. Additionally, the trauma of the banking crisis is likely to damage business and consumer confidence. His comments were echoed by the Prime Minister who said Britain's economic downturn is likely to cause a recession. Lord Mandelson, the new Business Secretary, acknowledged that it is now 'unavoidable' that the UK economy will contract and added that many small and medium-sized businesses might go bankrupt.

¶3. (SBU) Ernst & Young's ITEM Club agrees with recession predictions. In its quarterly macroeconomic forecast, the Club says it expects UK GDP to shrink by 1 percent next year, followed by a modest recovery in 2010 with GDP growth of 1 percent. If the Club is correct, 2009 will be the first full year of shrinking output since the last recession in 1991, when output fell by 1.4 percent over the year prior. The report also says that the credit crunch will hit the economy hard even if wholesale markets reopen and equity markets stabilize. It suggests that the downward momentum in the housing market will be difficult to arrest and that it is spreading to other sectors. While the recent government rescue package may have pulled the economy back from a depression, the report says the financial system remains in an enfeebled state. (Note: The financial sector accounts for approximately 10 percent of UK GDP and nearly 20 percent of tax receipts. End note.)

¶4. (SBU) NIESR, an influential UK think tank, agrees that the country is on the brink of recession. It forecasts that the British economy will suffer more than any other G7 country in 2009, with the economy shrinking by 0.9 percent, consumer spending falling by 3.4

percent, business investment down 3.8 percent and private housing investment 17.1 percent lower. Its forecast assumes that the Bank of England will cut the Bank Rate to 4 percent in early 2009. NIESR thinks that if the government's banking bail-out does not succeed, the recession will be deeper and longer than currently anticipated. The NIESR report also predicts that trend growth is now only 2.2-2.3 percent and said that this will have serious implications for HM Treasury revenue forecasts in the Pre-Budget Report that is expected in November.

Sterling At Five-Year Low On Recession Warnings

15. (SBU) Following Mervyn King's statement, the pound fell to a five-year low against the U.S. dollar. On October 22 sterling fell five cents or 3 percent against the dollar and also declined versus the euro, the lowest level since 2003. This was the steepest one day decline in 16 years. Simon Derrick, Chief Currency Strategist in London at Bank of New York Mellon Corp said "These are...moves that come along once in a decade...King certainly acted as a catalyst, but in fairness, risk aversion had been kicking around long before that."

Public Finances To Support Economy

16. (SBU) PM Brown told the House of Commons on October 20 that HMG will increase borrowing to support the economy. Despite public finances reaching a record deficit in the first six months of the financial year (which begins in April), Brown said increased borrowing is a viable option because of the strength of the UK's economic indicators. HMG will support mortgage holders, small firms and employees through "carefully targeted, rigorously worked through investments." HMG will also bring forward construction projects on schools and hospitals, the Chancellor told the Sunday Telegraph.

LONDON 00002683 002.2 OF 002

17. (SBU) Spending plans will be formally announced in the Chancellor's Pre-Budget Report. Speculation is rife that the Chancellor will have to announce an amendment to HMG's sustainable investment rule, implemented while Gordon Brown was Chancellor, which limits national debt to 40 percent of GDP. The Chancellor will also have to concede that the Treasury's economic forecast in the March Budget was too optimistic.

18. (SBU) In public comments, Opposition leader David Cameron accused the PM of aggravating the credit crunch by overseeing a decade of heavy borrowing and lax regulation. He said the government has presided over ten years of irresponsible capitalism and that the 'complete and utter failure' of their economic record is now clear. The Conservatives favor measures giving small businesses the chance to defer value-added tax (VAT) bills for up to six months to offset cash flow problems posed by tight credit conditions. They also advocate cutting the payroll taxes for firms with fewer than five employees by 1 percent.

19. (SBU) Comment: The UK's slide into recession was not unexpected. The OECD predicted almost two months ago that the UK was the most likely among G7 countries to experience such an economic downturn. Sterling's plummeting value vis-à-vis major economies will exacerbate pressures on exporters, who already have seen their access to credit dry up. While accelerated spending plans will give a shot-in-arm to the economy, no one expects any type of recovery until the latter half of 2010.

LEBARON